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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No.

In The Matter of

INDIAN LAKE ESTATES, INC., Bankrupt,

ERNEST L. STEWART, Trustee in Bankruptcy,
Petitioner,

v.

UNITED STATES OF AMERICA, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The petitioner is Ernest L. Stewart, the Trustee in Bankruptcy in the Matter of Indian Lakes Estates, Inc., Bankrupt. The petitioner respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit.

OPINIONS BELOW

The order of the District Court for the Middle District of Florida (February 18, 1969) (Appendix B, *infra*, p. 12a), affirming the order of the Referee in Bankruptcy, 24 AFTR 2d 69-5605, 69-2 USTC ¶ 9588 (D.C. Fla., 1968) (Appendix C. *infra*, pp. 13a-18a), is not officially reported. The opinion of the Court of Appeals (Appendix A, *infra*, pp. 1a-11a) is not yet reported.

JURISDICTION

The judgment of the Court of Appeals for the Fifth Circuit was entered on June 24, 1970, and this petition for certiorari was filed within 90 days of that date. The court's jurisdiction is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Sections 17(a)(1) and 64 of the Bankruptcy Act, as amended in 1966, accord priority only to taxes "which became legally due and owing by the bankrupt to the United States or to any State or any subdivision within three years preceding ankruptcy." Sections 17(a)(1)(a)-(e) provide certain limited exceptions. This petition involves one of the stated exceptions, section 17(a)(1)(c), which accords priority to taxes "which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt."

The question presented in this case is whether that exception applies to accord priority to Federal taxes which allegedly became due and owing five to seven

years prior to bankruptcy and which, at the time of bankruptcy had not been assessed where (1) the Government's claimed deficiencies related to allegedly improper deductions which were clearly set forth on the return, and (2) the Government had failed to mail a statutory notice of deficiency within three years of the filing of Indian Lakes' tax returns.

STATUTORY PROVISIONS INVOLVED

The pertinent provisions of Sections 17 and 64 of the Bankruptcy Act, [11 U.S.C. 35 and 104 as amended by Secs. 2 and 3, Act of July 5, 1966, P.L. 89-496, 80 Stat. 270] and Sections 6212(a), 6213(a), 6501(a), and 6503(a)(1) of the Internal Revenue Code of 1954 are set forth in Appendix D, *infra*, pp. 19a-22a. Unless otherwise noted, section references herein relate to the Bankruptcy Act, as amended. References to the Internal Revenue Code will be cited as I.R.C.

STATEMENT OF THE CASE

As a result of an audit of the corporate income tax returns of Indian Lakes Estates, Inc. (hereinafter called Indian Lakes) for fiscal years ended July 31, 1957, 1958, and 1959, the Internal Revenue Service asserted tax deficiencies. To avoid the ban of the three-year statute of limitations for assessing deficiencies, Internal Revenue asked Indian Lakes to execute extensions of the limitations period. Indian Lakes repeatedly executed such extensions—fifteen in all—with the effect that the statute of limitations on assessment was extended for all the years involved until June 30, 1966.

On April 16, 1965, following denial of a petition to reorganize under Chapter X of the Bankruptcy Act, the bankruptcy court granted Indian Lakes' voluntary

petition for bankruptcy. Prior to the adjudication of bankruptcy the Revenue Service had neither assessed the taxes claimed nor mailed a formal notice of deficiency, although all the claimed deficiencies relate to tax years five to seven years previous. On November 29, 1965, Internal Revenue notified the trustee in bankruptcy of the United States' priority claim for corporate income taxes owing for the years in question. Only thereafter, pursuant to the special bankruptcy provisions in I.R.C. section 6871, did Internal Revenue assess a deficiency. The additional taxes total nearly $1.5 million and result from the disallowance of certain deductions which Indian Lakes had claimed and clearly identified on its returns. No question has been raised as to the accuracy of the gross income reported.

The claims asserted by the Commissioner, if granted priority, will leave no assets from which to pay any of the claims of general creditors. The petitioner objected to giving these claims priority on the ground that, since they were for taxes which became "legally due and owing" more than three years prior to bankruptcy—as the government concedes they did for purposes of this case—they are dischargeable debts under section 17(a) and thus are not entitled to priority under section 64. The petitioner contends that under the Bankruptcy Act, as amended, Internal Revenue's stale tax claims should be treated the same as the claims of other unsecured creditors.[1]

Both the Referee in Bankruptcy and the District Court agreed with the petitioner. In reaching his deci-

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[1] Although the petition in bankruptcy here predated the 1966 amendments, the 1966 Act provides that it "shall govern proceedings . . . pending when it takes effect." Section 5(b), Act of July 5, 1966, P.L. 89-496, 80 Stat. 270. No question has been raised as to its applicability to this case.

sion, the Referee, whose opinion was adopted in full by the District Court, relied on section 17(a), which provides in part:

> [A] discharge in bankruptcy shall release a bankrupt from all his provable debts except such as (1) are taxes which become legally due and owing by the bankrupt to the United States . . . within three years preceding bankruptcy. [App. p. 19a]

Because the taxes here had not become legally due and owing within three years of bankruptcy, both the Referee and the District Court concluded that they were dischargeable. And, since section 64 provides that priority is given only to tax claims "which are not released by a discharge in bankruptcy," they sustained petitioner's objection to the assertion of priority.

The Referee rejected the Internal Revenue's argument that Indian Lakes' tax liabilities are not dischargeable because they come within the section 17(a)(1)(c) exception from dischargeability, which embraces:

> taxes . . . which were not reported on a return made by the bankrupt *and* which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt. [§ 17(a)(1)(c) (Emphasis Added).]

The Referee did not find it necessary to reach the question of whether the taxes were "reported on a return". Rather, he rejected Internal Revenue's argument that the taxes had not been assessed prior to bankruptcy "by reason of a prohibition on assessment". The Referee concluded that, although the Internal Revenue Code prevents any assessment until 90 days

after the mailing to the taxpayer of a formal notice of deficiency [I.R.C. § 6213(a)], nothing whatever prohibited the mailing of the notice itself during the five to seven years that elapsed between the filing of the returns and the adjudication of bankruptcy. Accordingly, both the Referee and the District Court denied priority to the Commissioner's tax claims.

On appeal to the Fifth Circuit Court of Appeals, the Government was apparently persuaded by the reasoning of the Referee, for in its brief before that court it specifically disavowed the argument that there was a prohibition on assessment pending the exhaustion of administrative remedies in this case. Instead, the Government maintained that Congress must have *intended* to exclude from dischargeability taxes which were unassessed during the pendency of administrative proceedings even though Congress had *said* it was excluding only those taxes which were not assessed "by reason of a prohibition on assessment" during that period.[2]

The Court of Appeals ruled in favor of the Government; it did not, however, adopt the Government's reasoning. Rather, the Court purported to rely on the "plain meaning" of the 1966 Bankruptcy Act amendments to conclude that there was indeed a prohibition on the assessment of taxes:

> Thus, if it is assumed that the draftsmen of the 1966 amendments understood tax law and are

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[2] "The government is contending that *notwithstanding the lack of a statutory prohibition against assessment pending* exhaustion of administrative remedies, Congress, when it amended section 17(a), intended to allow taxpayers the full use of their existing administrative remedies." Reply Brief for the Appellant before the Fifth Circuit in *In re Indian Lakes Estates, Inc.*, No. 27877, p. 3 (Emphasis added).

> deemed to have meant what they plainly said, an unassessed Federal tax liability is prohibited and therefore not discharged if the "ninety day letter" [the formal notice of the deficiency required by section 6213(a) of the Code] has not been sent out, regardless of how old the subject tax liability may be. [App. p. 8a]

The Court of Appeals then had to reach the question which the Referee and the District Court had bypassed: whether the taxes claimed were "not reported on the return." For, even if there were a prohibition on assessment, the taxes would not be accorded priority unless, under the second standard of the section 17(a)(1)(c) exception, they also were "not reported on the return." The Court ruled that they were not—*i.e.*, that even though the deductions which the Commissioner subsequently disallowed had been clearly shown on the returns, the bankrupt had not set forth the proper amount of his tax liability. Finding both requirements of section 17(a)(1)(c) satisfied, the Court of Appeals held that the taxes were entitled to priority.

REASONS FOR GRANTING THE WRIT

1. The decision below—that tax deficiencies for taxable years five to seven years prior to bankruptcy were entitled to priority over general creditors—frustrates the intention of the 1966 amendments to the Bankruptcy Act by which Congress sought to deny priority for taxes due more than three years prior to bankruptcy. If the Court of Appeals' ruling stands, virtually all Federal tax claims, no matter how old, will continue to enjoy priority, although that was clearly not the intention of Congress.

2. The Court of Appeals failed to consider alternative readings of section 17(a)(1)(c) of the Bankruptcy

Act which would make the 1966 amendments meaningful and carry out the intention of Congress.

3. As tax claims are filed in most bankruptcies, the present uncertainty concerning the impact of the 1966 Bankruptcy Act amendments on tax claims is causing intolerable confusion for trustees of bankrupt estates.

The Solicitor General has requested certiorari in *United States* v. *McGugin*, No. 241 October Term 1970 (petition for certiorari pending) and *California State Board of Equalization* v. *Carlson*, No. 150 October Term (petition for certiorari pending) which involve related provisions of the 1966 amendments to section 17(a) of the Bankruptcy Act. The issue in the present case is vastly more important in the administration of the bankruptcy laws than the issue raised in those other cases. Petitioner urges that certiorari be granted in this case and, if certiorari is granted in those cases, that consideration be given to setting this case for argument with the cases referred to above.

DISCUSSION

1. The Decision Below Renders the 1966 Bankruptcy Act Amendments Virtually Meaningless By Giving Priority to Taxes Allegedly Due and Owing 5-7 Years Prior To Bankruptcy Where the Clear Intent of Congress Was To Limit Priority to Taxes Which Became Due and Owing Within 3 Years of Bankruptcy

Before 1966, Federal, state, and local tax claims, no matter how old, were not discharged in bankruptcy and enjoyed priority over general creditors in all cases. In 1966—after similar bills had passed the House of Representatives in four successive Congresses and had been stalled in the Senate Finance Committee—Congress modified this rule by amending sections 17(a) and 64(a) of the Bankruptcy Act. The amendments generally provide that tax claims due and owing more than three

years prior to bankruptcy will no longer be accorded priority over unsecured creditors.[3] The clear purpose of the bill, according to the Senate Judiciary Committee Report, was:

> . . . to limit the priority accorded to taxes in the distribution of bankruptcy estates to those taxes which become legally due and owing within three years preceding bankruptcy.[4]

A primary, stated objective of the legislation was to protect general creditors from the sudden assertion by Internal Revenue of large, theretofore unpublished tax claims which had become due and owing from the taxpayer many years before the general creditors had unwittingly extended credit. As both the House and Senate Judiciary Committee Reports state:

> . . . [T]here is no limit under the present law on the priority accorded taxes.
>
> The result has frequently been that tax collectors, assured of a prior claim on the assets of a failing debtor and assured of the non-dischargeability of uncollectible tax claims, have allowed taxes to accumulate and remain unpaid for long periods of time. With the proliferation of new taxes and the increased rates of old taxes, often little or nothing

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[3] Section 64 was amended to provide that tax claims discharged in bankruptcy do not take priority over the claims of general creditors; section 17(a) was amended to provide that taxes which became due and owing more than 3 years prior to bankruptcy are discharged. Section 17(a) sets out a series of exceptions to the dischargeability of such stale claims. This case involves the scope of one of those exceptions. For a discussion of the long history of the attempts to amend the Bankruptcy Act, see Kennedy, *The Bankruptcy Amendments of 1966*, 1 Ga. L. Rev. 149 (1967).

[4] S. Rep. No. 1158, 89th Cong., 2nd Sess., 2 U.S. Code Cong. & Adm. News, p. 2468 (1966).

> is left for distribution to general creditors who provided goods and services to the bankrupt.[5]

The Congress felt that as to such tax claims the Government should share in the risk of business failures:

> Ultimately, however, the issue would appear to resolve into whether the Government as a creditor should bear part of the economic burden of business failures through the loss of some of its tax claims which it has allowed to accumulate over a long period of years.
>
> The Committee believes that limiting tax priority to those taxes which became due and owing within three years preceding bankruptcy adequately safeguards the public's interest in the collection of revenues while at the same time limiting the impact of long accumulated, unsecured tax claims on general creditors. The imposition of such a limitation will induce taxing authorities to act to prevent large accumulations of tax claims.[6]

It is clear from the legislative history that Congress sought to protect general creditors from long accumulated, unassessed tax claims by limiting priority to those taxes which became due and owing not more than three years prior to bankruptcy. This is accomplished by first providing that these stale taxes are dischargeable and then denying priority to discharged tax claims. Sections 17(a)(1) and 64. The dischargeability rule is not absolute, however; five exceptions to it are included, primarily to cover situations in which the Commissioner either legally could not act, or should not be expected to act, within the usual three-year period.

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[5] S. Rep. No. 1158, *supra*; H. Rep. No. 687, 89th Cong., 2nd Sess., 2 U.S. Code Cong. & Adm. News, p. 2471 (1965).

[6] House and Senate Judiciary Committee Reports, *supra*, p. 2471.

Exceptions (a) and (b)[7] provide that taxes owing more than three years prior to bankruptcy will not be discharged where the bankrupt has filed no return. Exception (d)[8] provides for nondischargeability where the bankrupt has filed a false or fraudulent return, and exception (e)[9] denies dischargeability for trust fund taxes that the bankrupt withheld from employees but did not pay over. A further proviso states that when the government has made an assessment and obtained a tax lien, that lien remains valid even where the taxes themselves have been due and owing more than three years. Section 17(a)(1)

This case involves Exception (c) to the dischargeability rule contained in section 17(a)(1) of the Bankruptcy Act. That exception was intended as a technical and narrow exception to the general rule of the 1966 amendments that unassessed claims for taxes which become due and owing more than three years prior to bankruptcy shall not take priority over the claims of general creditors. The Court of Appeals, however, has read the exception so broadly that it swallows up vir-

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[7] "... That a discharge in bankruptcy shall not release a bankrupt from any taxes (a) which were not assessed in any case in which the bankrupt failed to make a return required by law, or (b) which were assessed within one year preceding bankruptcy in any case in which the bankrupt failed to make a return required by law." Section 17(a)(1)(a) and (b).

[8] "... That a discharge in bankruptcy shall not release a bankrupt from any taxes ... (d) with respect to which the bankrupt made a false or fraudulent return, or willfully attempted in any manner to evade or defeat." Section 17(a)(1)(d).

[9] "... That a discharge in bankruptcy shall not release a bankrupt from any taxes ... (e) which the bankrupt has collected or withheld from others required by the laws of the United States or any State or political subdivision thereof, but has not paid over ...." Section 17(a)(1)(e).

tually all cases not covered by the other exceptions as well as many that are also covered by the other exceptions.

Exception (c) provides that claims for taxes owing more than three years prior to bankruptcy will not be discharged if the taxes:

> (i) "were not reported on a return made by the bankrupt," *and*
>
> (ii) "were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt."

Exception (c) was intended to preserve the Government's priority only where there are unreported tax liabilities which the Code prevents the Commissioner from assessing or collecting prior to bankruptcy. The Court of Appeals, however, has read this exception so that it will apply to *every* case involving an unassessed tax deficiency, regardless of whether the liability was revealed on the tax return and regardless of whether the Commissioner took the steps clearly available to him to assess and collect the deficiency.

Ordinary tax deficiencies uncovered by a Revenue Service audit are one of the most common sources of tax claims in bankruptcy. When coupled with the other exceptions to section 17, the Court of Appeals' unduly broad reading of Exception (c) will mean that the three-year limitation on tax priorities will almost never apply. This clear distortion of Congressional intention should not be permitted to stand.

The first error in the decision below involves the Court of Appeal's interpretation of the first clause of Exception (c) ("taxes not reported on a return"). The Court of Appeals thought that this requirement is satisfied in every case in which, for any reason, a

tax return fails to report the precise amount of taxes owing. But, by statutory definition, a "deficiency" is the amount by which the tax imposed by the Internal Revenue Code exceeds "the amount shown as the tax by the taxpayer on his return." I.R.C. § 6211. Thus, the Court of Appeals read the first clause of Exception (c) to cover *every* tax deficiency.

The court below also read the second requirement of Exception (c) ("taxes not assessed . . . by reason of a prohibition on assessment") as being met in *every* deficiency case. The Internal Revenue Code prohibits assessment by the Commissioner until at least 90 days after the mailing to the taxpayer of a notice of deficiency. I.R.C. § 6213(a). Based on that provision, the Court of Appeals ruled that there is a "prohibition on assessment" in every case in which the Commissioner has failed to mail a statutory notice of deficiency. Thus, under the Fifth Circuit's holding, both requirements of Exception (c) will be met in every case involving an unassessed tax deficiency, one of the most common sources of tax claims in bankruptcy and precisely the sort of tax claims which Congress thought should be discharged and should be denied priority if not assessed within three years.

Even before the 1966 amendments, deficiencies that were not assessed within the three-year statute of limitations were uncollectable, and hence, not provable debts in bankruptcy, much less debts entitled to priority. Such claims were valid only if extensions of the statute of limitations had been obtained from the taxpayer.[10] And it was only by securing such extensions that Internal Revenue could accumulate old claims to

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[10] Internal Revenue rarely has any trouble securing such extensions, for when faced with the threat of an immediate assessment, the taxpayer has little choice but to accede to Internal Revenue's request for his consent.

the detriment of general creditors. The legislative history makes clear that it was precisely such accumulations that Congress sought to prevent by enacting the amendments. Yet, under the Court of Appeals' reading of Exception (c), Congress has accomplished nothing. As before the 1966 amendments, all Internal Revenue need do to retain priority for its stale tax claims is to obtain extensions of the statute of limitations from the taxpayer—extensions of which the general creditors will usually be ignorant. This is certainly not what Congress intended by its 1966 enactment, and to read it this way is to render it virtually meaningless.

In its opinion the Court of Appeals conceded that its "construction does not accord with every broad intention announced by the Congress." (App. p. 9a) The Court of Appeals suggested, however, that requiring Internal Revenue to "force the issue" would precipitate more bankruptcies. Yet, Congress is entitled to make that judgment, and it clearly intended the Commissioner to "force the issue" or share in the risk of bankruptcy. As the Judiciary Committee reports state:

> In establishing what this limitation should be, the committee was concerned with its effect in forcing tax authorities to precipitate business failure in safeguarding the interest of the Government. For that reason, the committee rejected the one-year limitation on both priority and non-dischargeability which was proposed when the matter was considered in the 85th Congress. However, the committee believes that a business which is unable to meet tax obligations extending back more than 3 years is unlikely to recover financial viability. The continued failure to protect the Government's tax interest by instituting liens or distraint warrants generally results only in compounding the loss suffered by general creditors and the Govern-

> ment as well. Furthermore, the effect of forcing the financial issue may, in some cases, be to save debtor before his position becomes helpless.[11]

See also the statement of the bill's sponsor, Senator Ervin:

> It seems to me that the 3-year period which IRS is given to file a lien is reasonable, for it is identical with the period within which the Government has the right to assess taxes.[12]

Congress, then, clearly expected the Commissioner to initiate assessment procedures within three years after filing of a return, or else share with general creditors the risk of business failures. The Committee Reports are clear, specific and precise representations of the will of Congress, not the "broad generalizations" which the Fifth Circuit found to be "for all practical purposes, next to meaningless for the problem at hand." (App. p. 7a)

While the court below apparently felt that requiring Internal Revenue to "force the issue" or share the risk would simply precipitate more bankruptcies, it was obviously not for it to substitute its judgment for the clearly expressed will of Congress.[13] But, this is precisely what the court did by eviscerating the enactment itself through its reading of the exception. There

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[11] House and Senate Judiciary Committee Reports, *supra*, pp. 2471-2472.

[12] 112 Cong. Record, p. 13810.

[13] There is, moreover, no reason to think that the Commissioner will adopt the "arbitrary practice of assessment at the end of the three years" in every case, as the Court of Appeals feared. Rather, it is only in those cases where bankruptcy appears a real possibility that the assessment will in fact be made earlier than previously. And it is in precisely these situations that Congress wanted Internal Revenue to act more quickly.

is no sound basis for doing this, particularly when, as here, the language of the statute can reasonably be read in such a way as to preserve its import and effectuate its intent.

2. The Court of Appeals Failed To Consider Alternative Constructions for the Language of Exception (c) to Section 17(a)(1) of the Bankruptcy Act Which Would Have Given the 1966 Amendments a Reasonable Meaning and Would Have Carried Out the Intention of Congress

Each of the clauses of Exception (c) is ambiguous, but each can reasonably be read in a way which—unlike the Court of Appeals' interpretation—is not only in keeping with the intent of Congress in enacting the amendments but which also does less violence to the language of the exception itself. It should be noted that if the readings suggested here for *either* of the two clauses of Exception (c) is adopted, the tax claims in issue will lose priority.[14]

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[14] It should also be noted that loss of priority on certain of its claims in bankruptcy would have but a minute impact on Internal Revenue collections now in the $200 billion range. In the fiscal year ended 1966, for example, the total amount paid on all unsecured priority tax claims—both state and federal—was under $11.5 million. Tables of Bank. Stats. (Adm. Off. of U.S. Cts.). Much of this undoubtedly became due and owing within three years of bankruptcy, and thus would not have been lost to the government even if the amendments were interpreted in the way petitioner suggests. Moreover, even on tax claims which do not have priority, the government shares in the available assets of the estate with other unsecured creditors. To the general creditors of the bankrupt, however, the available assets taken to satisfy long accumulated tax claims may be very important indeed. As the Committee Reports state: "The Committee has received hundreds of letters from business firms all over the country complaining about the situation (the assertion of priority on old tax claims)." S. Rep. No. 1158, *supra;* H.R. No. 687, *supra.*

a. "Taxes . . . not reported on a return" refers to tax liabilities resulting from transactions not disclosed on a return

The Court of Appeals has read the first clause of Exception (c), "taxes . . . not reported on a return" in such a way that it becomes mere surplusage. The Court read this phrase as covering any case where there is a deficiency, *i.e.*, where the amount of tax liability shown on the return is less than the tax liability as ultimately determined. I.R.C. § 6211. But the second clause of Exception (c), too, applies only to cases where there is a deficiency; for it is only when there is an alleged deficiency that there can conceivably be a prohibition on assessment. This is because under I.R.C. section 6201 the Commissioner is required to assess immediately the tax liability reported on the taxpayer's return, and there is never a statutory prohibition on such an assessment. Thus under the Court of Appeals interpretation (a) the first clause applies in every case that the second clause applies, and (b) the second clause applies in every case that the first clause applies. It is inconceivable that Congress intended such redundancy.

Congress surely had some purpose in stating two separate requirements for the applicability of Exception (c), and that exception should be read so as to give meaning to both requirements. The first clause of Exception (c) should be interpreted to retain priority only for those unreported tax liabilities arising from items or transactions not disclosed on the return. Where a return is such as to adequately apprise the Commissioner of the nature and amount of the items which gives rise to a claimed deficiency, the Commissioner can be expected to take steps to assess the tax and, if he fails to do so in three years, he should

share the risk of bankruptcy with the general creditors. Precisely this construction of the phrase "taxes not reported on a return" was adopted by the Referee in Bankruptcy in *In re Michaud,* 24 AFTR 2d, 69-5978, 69-2 U.S.T.C. ¶ 9677 (W.D. Penn. 1969), the only opinion in which the phrase has received thoughtful attention.[15] There the Referee held that Exception (c) did not apply to preserve priority for claims due and owing more than three years prior to bankruptcy "where the facts and amounts of contested deficiencies are . . . set forth in the taxpayer's returns". 24 AFTR 2d, at 69-5982, 69-2 U.S.T.C. at 85,860.

An interpretation of the clause as applying only where the facts giving rise to the deficiency are not set forth in the return would be consonant with I.R.C. section 6501(e), the only section of the Internal Revenue Code that embodies a concept comparable to that of "taxes not reported on a return." Under section 6501(e), the usual three-year statute of limitations is extended to six years "if the taxpayer omits from gross income an amount properly includable therein which is in excess of 25 percent of the amount of gross income stated in the return . . . ." The 1954 Code specifically provides that in determining the amount omitted from gross income "there should not be taken into account

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[15] Aside from the decision of the Fifth Circuit in the instant case, the only case dealing with the issue at all is *In re Cohen,* 21 AFTR 2d 992, 68-1 U.S.T.C. ¶ 9250 (D.C. Ga. 1967). That case differs from this one in that there Internal Revenue had sent a formal notice of deficiency prior to bankruptcy and, at the time of bankruptcy, the taxpayer's petition was pending in the Tax Court. Thus, at the time of bankruptcy at least, there was a statutory prohibition on assessment. See n. 19 *infra.* Moreover, it is unclear whether or not the return in *Cohen* disclosed the transactions giving rise to the deficiencies.

any amount . . . if such amount is disclosed in the return . . . in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item." The companion section in the Internal Revenue Code of 1939 contained no specific reference to items disclosed in the return, but the courts reached the same result. *E.g., Davis* v. *Hightower,* 230 F.2d 549 (5th Cir. 1955); *Deakman-Wells Co.* v. *Commissioner,* 213 F.2d 894 (3rd Cir. (1954); *Uptegrove Lumber Co.* v. *Commissioner,* 204 F.2d 570 (3rd Cir. 1953). So long as the subsequently contested items are themselves shown on the return the Commissioner should be required to determine the deficiency within the normal statutory period or share the risk of bankruptcy with the bankrupt's general creditors.[16]

By this reading, the first clause of Exception (c) would be given significance and, moreover, would fit more comfortably in its statutory setting between the other perfectly reasonable exceptions which apply where the taxpayer has filed no return whatever, or has filed a fraudulent return. The latter cases, like that of the omission of an item from the return, are ones where the Commissioner may legitimately need additional

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[16] As the Court said in *Uptegrove Lumber Co.* v. *Commissioner, supra:*

> "And this restriction [on the class of cases where the 3 year statute of limitations is extended] is quite logical. For there are many places throughout an income tax return where a taxpayer may make arithmetical errors or claim improper deductions with the result that his tax liability is understated. If such errors are made in good faith at any place other than the gross income section, it is clear that the government must challenge them, if at all, within the normal 3 year limitation period." 204 F.2d at 572.

time. In the normal case of a deficiency discernible from the return itself, however, it is clear from the legislative history of the 1966 statute—both from committee reports and statements on the floor—that Congress expected the Service to act within the three-year statute of limitations or to share the risk of bankruptcy with the general creditors. (See Committee Reports, quoted pp. 9, 10, 14 and 15, *supra.*)

b. "Taxes . . . not assessed prior to bankruptcy by reason of a prohibition on assessment" preserves priority only as to taxes for which a statutory notice of deficiency has been mailed within the 3 year statute of limitations

The Court of Appeals was also wrong in its interpretation of the phrase "taxes which were not assessed prior to bankruptcy by reason of prohibition on assessment pending the exhaustion of administrative or judicial remedies". Despite the pendency of administrative tax proceedings at the time of the filing of Indian Lakes' petition in bankruptcy, the taxes in question had been due and owing for between five and seven years. During this period nothing prohibited Internal Revenue from instituting assessment procedures by mailing a statutory notice of deficiency.[17] Internal Revenue was at all times free—notwithstanding any administrative negotiations—to immediately trigger the assessment process by forwarding the "90 day" deficiency notice. *Luhring* v. *Glotzbach*, 304 F.2d 560 (4th Cir. 1962).

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[17] In its opinion, the Court of Appeals states "if the Commissioner were to adopt an arbitrary practice of assessment at the end of three years regardless of whether the amount of tax due has been resolved, the potential future creditors will not have any knowledge of the existence of the security interest created." (App. p. 10a). This is simply wrong, and is contradicted by the

The Court of Appeals purported to reach its contrary result by reference to the "plain language" of the statute. It neglected, however, to discuss the phrase "*by reason* of a prohibition." For even if it can be said that Internal Revenue could not have made an assessment at the time of bankruptcy because no statutory notice of deficiency had been sent, the plain *reason* that no assessment had been made in the intervening years was not because a prohibition on assessment existed, but simply because Internal Revenue had decided not to mail the notice of deficiency within the three years allowed by the statute of limitations.[18] Thus, it was not "by reason" of a prohibition on assessment that none was made, and Exception (c) should not be construed to apply.

The interpretation of Exception (c) suggested here is consistent with both its language and its purpose in the statutory scheme. Its effect would be to allow Internal Revenue three full years to send the notice of

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court's own statement two sentences later that "if the Commissioner wants to protect the tax against the trustee in bankruptcy and thus unsecured creditors, he must give notice of the lien .... Such publicity could affect the availability of future secured and unsecured credit to the debtor." (App. pp. 10a-11a.) It is precisely this publicity which the Congress thought potential future creditors were entitled to.

[18] It should be emphasized that petitioner is in no way arguing that Internal Revenue cannot obtain binding extensions of the statute of limitations from the taxpayer where the Commissioner, or the taxpayer, seeks to continue administrative proceedings aimed at settling the matter. I.R.C. section 6501(c)(4) explicitly provides for such extensions and nothing in the 1966 amendments of the Bankruptcy Act affects their validity in any way. So long as valid extensions are obtained, the tax claims at issue remain collectable no matter how old they may be. But where such extensions are secured, the 1966 amendments require that the Commissioner share in the risk of bankruptcy.

deficiency, and if the notice was sent within that time, its tax claims would be nondischargeable and entitled to priority. On this interpretation the exception would dovetail with the basic three-year statute of limitations of the Code, which provides, at section 6503(a), that *after the mailing of the notice of deficiency* the running of the statute is suspended "for the period during which the Secretary . . . is prohibited from making the assessment." In other words, if the exception is read in this way, Internal Revenue would be protected in the situation where the notice of deficiency is sent just prior to the elapse of three years, and the taxpayer goes bankrupt during the succeeding period when I.R.C. section 6213(a) prohibits an assessment.[19]

This result would then be consistent with the extensive legislative history indicating that, by its enactment, Congress intended to require Internal Revenue to act within the normal statutory period or, as to taxes due and owing more than three years, take its chances—like any general creditor extending credit—on future bankruptcy.

3. The Uncertainty About the Proper Interpretation of the 1966 Amendments Has Caused Confusion in the Administration of Bankrupt Estates

The 1966 amendments have not yet been authoritatively construed by this Court, and the uncertainty about their proper application is causing intolerable confusion. For example, in the proposed reorganiza-

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[19] At the very least a "non-assessment by reason of a prohibition" under Exception (c) should be found to exist only when, at the time of bankruptcy, there is in fact an outstanding statutory notice of deficiency (or pending proceedings in the Tax Court) which, under I.R.C. § 6213(a), prohibits an assessment.

tion of Webb & Knapp, Inc.—a Chapter X proceeding involving thousands of shareholders and creditors of a publicly owned company—the government is seeking priority for a $35 million tax claim. That claim is for tax deficiencies for taxable years up to 12 years prior to bankruptcy, and if the government's claims in fact have priority, nothing will be left for the general creditors. Until the status of the tax claim is resolved, the trustee cannot intelligently propose a plan of reorganization or decide whether to recommend straight bankruptcy. See *In re Webb & Knapp, Inc., Report of the Trustee of the Debtors in Reorganization,* pp. 81 and 92 (Submitted to District Judge McLean, S.D. N.Y., Jan. 30, 1970).

Given the ambiguities in the 1966 amendments, and the importance of the issues involved, it is inevitable that this Court resolve the issues. Until this Court acts, the status of stale tax claims in bankruptcy will remain uncertain.

Under the Fifth Circuit's decision in the present case, such claims, no matter how old, will invariably be entitled to priority. Unlike that court, however, the Referee in Bankruptcy in *Michaud, supra,* and the Referee and District Court below, read Exception (c) so as to preserve the salutary effect which the 1966 amendments were intended by Congress to have. Similarly, the Ninth Circuit, in *U. S.* v. *McGugin,* No. 241 October Term, 1970 (petition for certiorari pending) and *California State Board of Equalization* v. *Carlson,* No. 150 October Term, 1970 (petition for certiorari pending), has read another somewhat ambiguous proviso to section 17(a) in a manner consistent with Congress' purpose. In those cases, the lien proviso to the 1966 amendments is involved, and, as in this case, the

Government in *McGugin* is arguing for an interpretation that would undercut the amendments themselves.[20]

Petitioner urges that certiorari be granted in this case and, should certiorari be granted in *McGugin* and *Carlson*, consideration be given to setting this case for argument with them. For although those cases involve different exceptions to dischargeability, they raise very similar questions of Congress' intent in enacting the 1966 amendments and essentially the same legislative history must be considered in arriving at a decision in all three cases.

CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to review the judgment and opinion of the Court of Appeals for the Fifth Circuit.

Respectfully submitted,

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[20] At issue in *McGugin* is whether the 1966 amendments preclude the enforcement of a pre-bankruptcy federal tax lien against assets acquired by the taxpayer after bankruptcy where the tax obligations secured by the lien predated bankruptcy by more than three years. *Carlson* presents precisely the same issue, but there state rather than federal tax obligations are involved.

APPENDIX A

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 27877

In the Matter of:

INDIAN LAKE ESTATES, INC., Bankrupt

UNITED STATES OF AMERICA, *Appellant*,

v.

ERNEST L. STEWART, Trustee in Bankruptcy, *Appellee*.

Appeal from the United States District Court
for the Middle District of Florida

(June 24, 1970)

Before BROWN, Chief Judge, COLEMAN and CLARK,
Circuit Judges.

CLARK, Circuit Judge: This mortal court must attempt to divine the intent of Congress in a situation where that intent may well be known only to the Divine. We must say what Congress meant by two brief phrases in a technical proviso passage of an amendment to the dischargeable debt provisions of the bankruptcy laws when an exhaustive examination by counsel for both parties and this Court of the history of the legislative processes leading to this enactment fails to disclose that the meaning or the significance of the language critical to our decision was ever really considered. The circumstance of such an

obscure history requires that the plain meaning of the language used must prevail, and this means the Referee in Bankruptcy and the District Court were in error. Since the taxes in contention here were not "reported on a return made by the bankrupt" and were not assessed prior to bankruptcy "by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt," they are not dischargeable in bankruptcy and are entitled to priority. We therefore reverse.

An examination of income tax returns filed by Indian Lake Estates, Inc., for the corporate fiscal years ending July 31, 1957, 1958 and 1959 disclosed questions as to allowable deductions claimed and the treatment of certain income items. Routine administrative adjustment procedures within the Internal Revenue Service were commenced. The matter involved substantial legal and factual issues and undoubtedly was complicated by related litigation.[1]

In order to prevent the interruption of audit and conference procedures then in process, the taxpayer and the Internal Revenue Service executed agreements on standard printed forms (Form 872) entitled, "Consent Fixing Period of Limitation Upon Assessment of Income and Profits Tax". A total of fifteen such agreements were executed which, combined, had the effect of extending the assessment period for all corporate fiscal years involved to June 30, 1966.

Following an unsuccessful attempt to reorganize under Chapter X of the Bankruptcy Act,[2] Indian Lake Estates, Inc. was adjudicated a bankrupt on April 16, 1965. No notice of deficiency[3] or assessment of tax[4] for the fiscal

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[1] Indian Lake Estates, Inc. v. Litchman, 311 F. 2d 776 (D.C. Cir. 1962); Indian Lake Estates v. Ten Individual Defendants, 350 F.2d 435 (D.C. Cir. 1965); Indian Lake Estates, Inc. v. Special Investments, Inc., 154 So.2d 883 (Fla. App. 1963).

years in question had been given or made prior to this adjudication of bankruptcy, but subsequent thereto the United States filed proof of a priority claim for income taxes for these three years together with a claim for additional employment taxes incurred by the bankrupt corporation in 1964 and 1965. The trustee objected to according priority status to the claim of the United States, contending that the income taxes covered were dischargeable debts under the provisions of § 17a of the Bankruptcy Act [5] and, therefore, not entitled to a priority status under § 64 of that Act.[6] First the Referee and then the district court sustained this objection. The United States appealed that last decision here.

No issue is raised as to the correctness or amount of the taxes claimed. The only issue posed is dischargeability *vel non*. Its legal corollary, priority, follows as of course from the language of § 64. The ultimate question then is this: Do these 1957, 1958 and 1959 taxes enjoy a priority claim upon the assets of the bankruptcy or does the United States have to take its position in the hodge podge of common creditors and accept a pro rata distribution?

The answer turns entirely upon the meaning of § 17a of the Bankruptcy Act.[7]

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[2] 26 U.S.C.A. § 501 et seq. (1967). The District Court refused to approve the petition and dismissed the proceeding.

[3] Int. Rev. Code of 1954, § 6212.

[4] Int. Rev. Code of 1954, § 6201(a)(1).

[5] 11 U.S.C.A. § 35a (Supp. 1970).

[6] 11 U.S.C.A. § 104(a)(4), Supp. (1970).

[7] We have considered the possible effect of the general priority statute—31 U.S.C.A. § 191 (1954). However, 11 U.S.C.A. § 104 (Supp. 1970) now disestablishes the priority of taxes over general unsecured creditors as to taxes discharged by bankruptcy, to the extent that it limits the priority of taxes over general creditors to those taxes which are not dischargeable. To this extent the later statute, 11 U.S.C.A. § 104 (Supp. 1970), constitutes a *pro rata* amendment of 31 U.S.C.A. § 191 (1954).

In pertinent part, that section reads:

> "(a) A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as (1) are taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof within three years preceding bankruptcy: *Provided, however,* That a discharge in bankruptcy shall not release a bankrupt from any taxes (a) which were not assessed in any case in which the bankrupt failed to make a return required by law, (b) which were assessed within one year preceding bankruptcy in any case in which the bankrupt failed to make a return required by law, (c) which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt, (d) with respect to which the bankrupt made a false or fraudulent return, or willfully attempted in any manner to evade or defeat, or (e) which the bankrupt has collected or withheld from others as required by the laws of the United States or any State or political subdivision thereof, but has not paid over; . . . . *And provided further,* That a discharge in bankruptcy shall not release or affect any tax lien; . . . ."

The United States concedes for the purposes of this action a question that could be fraught with difficulty, i.e. that the taxes in question became legally due and owing more than three years prior to bankruptcy. No issue is presented as to any failure to file a return or as to the filing of a false or fraudulent return or as to any attempt to evade or defeat taxes. The taxes here involved were not collected or withheld from others. The Director of Internal Revenue did not make an assessment prior to bankruptcy through regular or jeopardy processes and, that being true, no notice of tax lien was ever filed of record.

Our concern in the case sub judice may be further narrowed to the meaning of proviso (1)(c). This decision then turns upon whether the claimed income taxes were (i) not reported on a return made by the bankrupt, and (ii) not assessed prior to bankruptcy by reason of a prohibition on assessment pending exhaustion of administrative or judicial remedies available to the bankrupt.

Although both parties cite us to testimony, committee reports and debates, which we have examined together with other such material extending back to the introduction of this legislation in the First Session of the Eighty-fifth Congress, we fail to preceive any really meaningful legislative history that would assist in the interpretation of these passages.

For several sessions prior to the Second Session of the Eighty-ninth Congress, similar legislation had passed the House of Representatives but failed to clear the Committee on Finance of the Senate.[7a] It was apparently consigned to a similar fate in 1966 when a companion Senate bill [8] and the present law, which then had already passed the House of Representatives,[9] were referred to the Senate Committee on Finance and received unfavorable reports.[10] The situation changed dramatically, however, when the Finance Committee was discharged and the House and Senate bills were then referred by the Senate to the Senate Committee on the Judiciary, which rendered a unanimously favorable report and brought the legislation to the floor of the Senate. Its report [11] declared the fundamental policy

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[7a] The entire history of these amendments goes back over twenty years. See Kennedy, The Bankruptcy Amendments of 1966, 1 Ga. L.R. 149, 171-172.

[8] S. 976, 89th Cong., 2d Sess. (1966).

[9] H.R. 3438, 89th Cong., 2d Sess. (1966).

[10] S.Rep. Nos. 996 & 998, 89th Cong., 2d Sess. (1966). *See also* S.Rep. No. 999, 89th Cong., 2d Sess. (1966).

[11] S.Rep. No. 1158, 89th Cong., 2d Sess. (1966).

of the Bankruptcy Act to be twofold: (1) the effective rehabilitation of the bankrupt, and (2) the equitable distribution of the bankrupt's assets among the creditors.

Effective rehabilitation was pointedly intended to provide relief for *individual* bankrupts. A contrast was drawn between corporate bankrupts who carried no practical burden even when saddled with enormous after-bankruptcy tax liabilities, since their artificial entity could be dissolved. Natural persons, on the other hand, who went into bankruptcy with large tax debts remained burdened with such debts and their intended and desired rehabilitation was inequitably hindered.

The problem of equitable distribution of assets among creditors had a twofold aspect. The first aspect concerned today's increasingly large tax debts which enjoyed a priority status ahead of general creditors. Second, such tax claims could be of an entirely secret nature, unknown and unknowable to those who dealt with the bankrupt and extended him credit. Congress, in the course of debates and reports, frequently said it intended for the 1966 amendments to press taxing authorities to act more expediently in dealing with tax claims, both so that they would not cumulate to ruinous proportions and so that their existence could be more promptly known to general creditors. It was pointed out that other nations had long limited the number of years that tax debts could enjoy priority under their respective bankruptcy laws and it was felt the United States could and should do the same.

Obviously, the damage to the public purse was the balancing policy consideration. Congress was unwilling to eliminate all priority and ultimately settled on a time limit which it thought struck a proper balance. Provisos were added to prevent granting any benefit resulting from fraud or tax evasion. The time limit, which had been one year in the bill as originally presented, was extended to three years to permit a time comparable to the statute of limitations on tax debts for audit and examination.

But these broad generalizations are, for all practical purposes, next to meaningless for the problem at hand. From all we have been able to discover, the specific proviso which controls the case at bar just never received direct public congressional attention or explication.

Finding no helpful legislative history, we must look to the plain meaning of the enactment. *See Gemsco* v. *Walling*, 324 U.S. 244, 65 S.Ct. 605, 89 L.Ed. 921 (1945); cited with approval in Ex Parte Collett, 337 U.S. 55, 89 S.Ct. 944, 93 L.Ed. 1207 (1949).

Since the Referee and the court below considered only whether there was a prohibition on the assessment of taxes pending the exhaustion of administrative or judicial remedies, we shall treat with that point first. Int. Rev. Code of 1954, § 6213(a)[12] very clearly imposes prohibitions on the assessment of taxes:

(1) unless and until a notice of deficiency (most frequently referred to as the 90-day letter) is sent to the taxpayer.

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[12] "TIME FOR FILING PETITION AND RESTRICTION ON ASSESSMENT.—Within 90 days, or 150 days if the notice is addressed to a person outside the States of the Union and the District of Columbia, after the notice of deficiency authorized in section 6212 is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. Except as otherwise provided in section 6861 no assessment of a deficiency in respect of any tax imposed by subtitle A or B or chapter 42 and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day or 150-day period, as the case may be, nor, if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final. Notwithstanding the provisions of section 7421 (a), the making of such assessment or the beginning of such proceeding or levy during the time such prohibition is in force may be enjoined by a proceeding in the proper court."
Int. Rev. Code of 1954, § 6213(a).

(2) until the expiration of the waiting period required if no petition be filed in the Tax Court after such notice of deficiency has been served, and

(3) if a petition be filed in the Tax Court, until the decision of the Tax Court becomes final.

This prohibition is not absolute since assessment can be made if the collection of the tax is found to be in jeopardy. Int. Rev. Code of 1954, § 6861(a). The availability of the jeopardy assessment procedure does not, however, affect the conclusion that the § 6213(a) requirement is a "prohibition." This is because "jeopardy assessments . . . are *continuing* procedures. A taxpayer may achieve removal of a jeopardy assessment by proving no jeopardy of collection actually exists. He can then institute lengthy defensive maneuvers, possibly taking years, during which period the taxpayer's financial conditions may so deteriorate that a jeopardy assessment could subsequently be gained." Lurvey, Tax discharge in bankruptcy: how the new rules work; difficulty in planning, 28 J. Taxation 242, 243 (1968). *See also* Int. Rev. Code of 1954, § 6863: Plumb, Federal Liens and Priorities—Agenda for the Next Decade, 77 Yale L. J. 228, 266-68 (1967).

Thus if it is assumed that the draftsmen of the 1966 amendments understood tax law and are deemed to have meant what they plainly said, an unassessed federal tax liability is prohibited and therefore not discharged of the "90-day letter" has not been sent out, regardless of how old the subject tax liability may be. Certainly this is true in cases such as the one at bar where, due to the complicated nature of the taxpayer's legal affairs, lengthy administrative negotiations with numerous extensions of the statute of limitations are still pending and executory. Most authoritative articles on this subject accord with this interpretation. Plumb, Federal Liens and Priorities —Agenda for the Next Decade, supra: Plumb, Federal

Tax Liens and Priorities in Bankruptcy—Recent Developments, Journal of the National Conference of Referees in Bankruptcy, April 1969, 37, 43, 44; March, Triumph or Tragedy?—The Bankruptcy Act Amendments of 1966, 42 Wash. L.R. 681, 691-697. *See also* Lurvey, Tax discharge in bankruptcy: how the new rules work; difficulty in planning. Supra, at p. 242.

Since we conclude that the Referee and the district court were in error in ruling that the assessment of the taxes in the case at bar was not prohibited pending exhaustion of administrative remedies, we must reach the second question of law which these authorities pretermitted: were the taxes in the instant case taxes which were "not reported on a return made by the bankrupt"? We are not presented with a situation where the taxpayer filed a fraudulent or evasive return. It appears that the reason for the assessment arose because of a difference of opinion in the resultant tax liability properly attributable to a non-fraudulent return. It is obvious that the assessment was for the difference between the amount shown by the taxpayer on its return and the amount calculated as correct by the Director.[13] It is equally transparent that it was therefore an assessment for an amount of taxes not reported on a return made by the bankrupt. The only reported case the parties and this court have found agrees. In re Cohen, 68-1, U. S. Tax Cas. ¶ 9250 (Ref. ND Ga. 1967). A leading text reaches a similar conclusion. 1 Collier, Bankruptcy, ¶ 17.14[4] (14th ed. 1967). *See also* Plumb, Federal Tax Liens and Priorities in Bankruptcy—Recent Developments, supra, at p. 44.

We are well aware that this construction does not accord with every broad intention announced by the Congress. Unrecorded and unpublicized tax indebtednesses can still accumulate (with the combined agreement of the taxpayer

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[13] Compare the Definition of a Deficiency, Int. Rev. Code of 1954, § 6211.

and the Director of Internal Revenue to extensions of the assessment of tax) beyond the specified three-year limitation period. Large build-ups of taxes without creditor knowledge or knowability are thus possible, but the contrary construction is not as good an answer to this problem. If the Director is required to immediately assess, the interested parties are likely to be worse off in every case.

The assessment is, in fact, the origin of the "secret tax lien" with which Congress was so concerned.[14] If the Commissioner were to adopt an arbitrary practice of assessment at the end of three years regardless of whether the amount of tax due has been resolved, potential future creditors will not have any knowledge of the existence of the security interest created. The reason that the taxpayer would fare better if no assessment had been made is because with assessment all of the debtor's property[15] will be subject to the lien where without assessment they would be facing only a priority.[16] Moreover, if the Commissioner wants to protect the tax against the trustee in bankruptcy and thus unsecured creditors, he must give notice of the lien under the provisions of Int. Rev. Code of 1954, § 6321. *United States* v. *Speers,* 382 U.S. 266, 86 S.Ct. 411, 15 L.Ed.2d 314

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[14] "Unless another date is specifically fixed by law, the lien imposed by section 6321 shall arise at the time the assessment is made and shall continue until the liability for the amount so assessed (or a judgment against the taxpayer arising out of such liability) is satisfied or becomes unenforceable by reason of lapse of time." Int. Rev. Code of 1954, § 6322.

[15] "If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person." Int. Rev. Code of 1954, § 6321.

[16] A consideration of major importance to those creditors that are given a priority higher than the taxing authorities. See 11 U.S.C.A. § 104 (Supp. 1970).

(1965). Such publicity could affect the availability of future secured and unsecured credit to the debtor. This could result in financial failure, and all of this when the extent of the tax obligation may not have been fully determined.

Finding that the taxes which are the subject to this appeal were not reported on a return made by the bankrupt and were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt, we reverse and remand for further proceedings consistent with this opinion.

REVERSED AND REMANDED.

APPENDIX B

UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA

Order Affirming Referee's Order Entered January 17, 1968

(Filed: Feb. 18, 1969)

THIS CAUSE came on to be heard upon the petition for review of that certain order entered in this cause on January 17, 1968 by the Referee in Bankruptcy of this Court. The Court has considered the Referee's certificate of review filed herein, the items attached to and made a part thereof, memoranda and argument of counsel and being advised, and on the basis of the reasons set forth in the memorandum opinion, which is a part of said order, it is,

ORDERED and ADJUDGED:

That said order is affirmed.

DONE and ORDERED at Tampa, Florida, this 18th day of February, 1969.

/s/ BEN KRENTZMAN
Ben Krentzman
United States District Judge

APPENDIX C

UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA

No. 65-79-T

IN THE MATTER OF INDIAN LAKES ESTATES, BANKRUPT.

Memorandum Opinion and Order on Trustee's Objection to the Claim of the United States Government

PASKAY, Referee:

Following an unsuccessful attempt to reorganize under Chapter X of the Bankruptcy Act, Indian Lake Estates, Inc., was adjudicated bankrupt on April 16, 1965. Thereafter on November 29, 1965, a Form 7900 Letter was sent by the Internal Revenue Service to the trustee advising that a determination had been made that the bankrupt was indebted to the Government for income taxes for the fiscal years ended July 31, 1957, 1958 and 1959, in the total amount of $1,020,767.55, plus penalties in the amount of $58,794.62, for failure to file timely returns for the fiscal years 1958 and 1959, as provided by Section 6651(a) of the Internal Revenue Code of 1954. On December 1, 1965, these income tax liabilities were assessed in accordance with the provisions of Section 6871 of the Code, and subsequently a proof of claim was filed by the United States asserting the liabilities plus interest thereon to April 16, 1965. The proof of claim also asserts the bankrupt's liability for employment taxes for the year 1964 and the first and a part of the second quarters of 1965 in the total amount of $1,673.63.

The Form 7900, hereinafter referred to as the 90-day letter, informed the trustee that the income tax deficiencies resulted from the adjustment of various specified items appearing on the tax returns filed by the bankrupt for its fiscal years 1957 through 1959, and that the deficiencies related primarily to the disallowance of certain deductions

claimed on the returns. In particular it was determined that deductions for compensation of officers was excessive, deductions for amortization of bond discount were improper since the advances to the corporation represented by the bonds were contributions of capital rather than loans, and deductions for discount on sales of sales of contract receivables were unallowable since the sales occurred between related persons. Further, it was determined that claimed deductions for net operating loss carryovers and carry-backs to these years should be reduced by virtue of adjustments in the prior and subsequent years where the operating losses were incurred.

Initially, the trustee challenged the government's claim and urged the claim be disallowed in toto on the ground that since the taxes involved were not assessed within the three years subsequent to the filing of the return, the Government is barred by virtue of Section 6501(a) of the Internal Revenue Code to collect these taxes for the years, 1957, 1958 and 1959. Subsequent to the hearing the Government, without objection of the trustee, submitted documentary evidence which indicates that the statutory limitation was tolled because the Internal Revenue Service and the taxpayer-bankrupt entered into an agreement for each of the years in question extending the period for the assessment u pto June 30, 1966 as permitted by Section 6501(c)(4) of the Internal Revenue Code of 1954.

Accordingly, it is no longer contended by the trustee that the Government is barred to make the assessment now and attempt to collect the taxes in question, however, it is the position of the trustee that even though the Government might have a provable claim, the same is no longer a non-dischargeable claim and, therefore, no longer entitled to priority treatment which is traditionally accorded to tax claims because the recent amendment of Section 17a and 64a of the National Bankruptcy Act which reads in pertinent parts as follows:

Bankruptcy Act, C. 541, 30 Stat. 544:

Sec. 17 (as amended by Sec. 2, P. L. 89-496, 80 Stat. 270) Debts not effected by discharge.—

> a. A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as (1) are taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof within three years preceding bankruptcy: Provided, however, that a discharge in bankruptcy shall not release a bankrupt from any taxes * * * (c) which were not reported on the return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt, * * *.
> (11 U.S.C. 1964 ed., Sec. 35.)

Sec. 64 (as amended by Sec. 3, P.L. 89-496, 80 Stat. 270) Debts which have priority.—

> A. The debts to have priority in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment shall be * * * (4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by discharge in bankruptcy: Provided, however, that no priority over general unsecured claims shall pertain to taxes not included in foregoing priority; * * *.

The Government concedes that in light of the undisputed facts that the taxes in question became legally due and owing for more than eight years prior to bankruptcy the income tax liability involved here would be discharged and in turn denied priority treatment but the exceptions set forth in the amendment of Section 17a(1)(c) and quoted above and the corresponding section set forth in Section 64a(4).

The savings proviso relied on by the Government is subparagraph (1) which exempts taxes from the three-

year limitation provided by Section 17a which (1) were not reported on the return made by the bankrupt and (2) which were not assessed prior to bankruptcy by reason of a prohibition against assessments pending exhaustion of administrative or judicial remedies available to the taxpayer.

The resolution of the controversy at bar involves, of course, the interpretation of Section 17a(1)(c) quoted above, the other subsections not being applicable. The soluton would depend on whether or not the two factors embodied in the proviso are or are not present in the controversy under consideration, since these factors are stated in the adjunctive it is clear that both must be found to be present before the savings provisio becomes operative. These factors as they relate to the case under consideration would be present if, first, the term "taxes not reported" includes taxes resulting from a subsequent determination of a deficiency and the term is not limited to taxes not reported on income not reported; second, if the Government is prohibited under the law to make an assessment when the Government and the taxpayer agrees to extend the three-year statute of limitation in accordance with Section 6501(c)(4) of the Internal Revenue Code of 1954. The problem appears to be of first impression and research of counsel and independent research failed to discover any authoritative text or decision furnishing a ready solution of the controversy. Subsequent to the submission of briefs the Government submitted for consideration the case of Matter of Leon Allen Cohen, Case No. 58290, U.S.D.C. for the Northern District of Georgia, Atlanta Division, which decision is unreported. The case was submitted to support the Government's theory that the tax deficiency constitutes "taxes not reported on the return made by the bankrupt" within the meaning of Section 17a(1)(c) and in fact the case so holds.

This holding, while it is not binding on the court would be persuasive if the facts involved in the case are sufficiently identical with the facts of this controversy and it is in

accord with the intent of Congress, as expressed by the legislative history of the amendments under consideration. This is not the case, however. In the Cohen case, the Government notified the bankrupt-taxpayer of the alleged deficiency on December 24, 1964. The taxpayer, within 90 days allowed by the statute (Sec. 6213 of the Internal Revenue Code) challenged the deficiency determination in the Tax Court by filing a petition on March 25, 1965 and sought a redetermination of the alleged deficiency. On the date of the bankruptcy proceeding there was an undetermined petition pending in the Tax Court. Thus, it is clear that in the Cohen case the Government was prohibited by law to make the assessment until the taxpayer's petition was ultimately determined. See Section 6213-6215 of the Internal Revenue Code; Marwell v. Campbell, 205 F.2d 461 (CCA 5). Thus, the factual situation involved in the Cohen case is definitely different from the facts involved in the present controversy. In the case under consideration, the Government waited eight years from the time the taxes were due and owing before it decided to send the letter. True enough prior to the expiration of the statute of limitation covering the respective years the Government and the taxpayer entered into an extension, but the Government was certainly not bound by such an agreement and the fact of the matter is that it could have, if it so desired, sent the 90-day letter the very day such an agreement was executed. While the Government's contention is correct that it was prohibted to make an assessment until the statutory notice, or the so-called 90-day letter is sent to the taxpayer, (Treasury Regulation 301.6213-1(a)(2) what the Government fails to point out is that there was no regulation or statute which prohibited the Government to send the 90-day letter and by doing so put the burden on the taxpayer to challenge the deficiency determination and if then the taxpayer has failed to petition the Tax Court within 90 days, to make the assessment.

Did Congress intend by enacting the amendment under consideration to except from the operation of Section 17a

tax claims which were admittedly due and owing longer than three years just because the taxpayer agreed with the Government to extend the time to make the assessment? The legislative history involving the amendments clearly indicates to the contrary. Senate Resolution No. 1158 which was submitted in support of the amendments, reveals that Congress was concerned primarily with two distinct problems. First, the unlimited dischargeability feature of the taxes and second, the equitable distribution of assets of the bankrupt's estate among creditors. The Committee Report of the House of Representatives, No. 687 clearly indicates that the Committee considered the fact that different types of taxes present different problems to tax collectors and the Committee decided that the three-year time limitation proposed was appropriate under the circumstances because it was the Committee's belief that such period would not impose an unrealistic or unfair burden upon taxing authorities and it is ample time to *audit returns and assess deficiencies* (emphasis supplied). The proposed amendments were vigorously opposed by the Treasury and in order to assure that the amendment will not be used as a facile device to evade just tax obligations and to assure this the proviso including the proviso under consideration was inserted. The general tenor of all savings proviso indicates that it was enacted for the purpose of assuring that the three-year cut-off period is inapplicable in cases where the taxpayer, because of an affirmative action or because of his failure to comply with the law regarding filing of returns prevented the Government either to determine the correct amount of taxes or to make an assessment. The legislative history clearly indicates that Congress considered it to be unfair and inequitable to permit the Government to accumulate unpaid taxes for a long period of years and then to come in and at the expense of the unsecured creditors collect its taxes by asserting its statutory priority. The Congressional reports indicate it was the intention of Congress that the Government, as a creditor, should bear part of the

economic burden of business failures and lose some of its tax claims which it has allowed to accumulate beyond the three-year period provided for by the proposed amendments. It cannot be gainsaid that it was a deliberate determination of Congress that three years is sufficient to make deficiency determinations. For this reason it would completely nullify the clear and express intent of Congress to hold that the execution of an agreement to extend the period of limitation saves the Government from the requirement to make a deficiency determination within the three years provided by the amendment. Whether or not deficiency itself as a tax, therefore, it is a "tax not reported" within the meaning of Section 17a(1)(c) or it is merely an adjustment of a tax reported, is of no consequence, inasmuch as the second factor which is essential for the operation of the savings proviso is clearly not established by the facts of this case.

Accordingly, it is the opinion of the court that the Government was not prohibited to make an assessment within the meaning of Section 17a(1)(c) and since the taxes for which the Government now claims priority were admittedly incurred and became legally due and owing for more than three years preceding the bankruptcy these taxes are dischargeable by virtue of Section 17a of the National Bankruptcy Act as amended and correspondingly, not entitled to priority by virtue of Section 64a(4) as amended. It is, therefore, upon consideration,

Ordered, Adjudged and Decreed:

That the trustee's objection to claim as pertains to the priority status of the bankrupt's 1957, 1958 and 1959 taxes, be, and it is hereby granted and disallowed as prior with leave granted to the Government to assert the same as an unsecured general claim. This determination shall not preclude the trustee to challenge the correctness of the alleged deficiency and present the controversy in a proper form for determination to this court.

APPENDIX D

Bankruptcy Act:

Sec. 17 [11 U.S.C. 35, as amended by Sec. 2, Act of July 5, 1966, P.L. 89-496, 80 Stat. 270]. *Debts Not Affected by a Discharge.* a. A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as (1) are taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof within three years preceding bankruptcy: *Provided, however,* That a discharge in bankruptcy shall not release a bankrupt from any taxes (a) which were not assessed in any case in which the bankrupt failed to make a return required by law, (b) which were assessed within one year preceding bankruptcy in any case in which the bankrupt failed to make a return required by law, (c) which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt, (d) with respect to which the bankrupt made a false or fraudulent return, or willfully attempted in any manner to evade or defeat, or (e) which the bankrupt has collected or withheld from others as required by the laws of the United States or any State or political subdivision thereof, but has not paid over; but a discharge shall not be a bar to any remedies available under applicable law to the United States or to any State or any subdivision thereof, against the exemption of the bankrupt allowed by law and duly set apart to him under this Act: *And provided further,* That a discharge in bankruptcy shall not release or affect any tax lien; * * *

Sec. 64 [11 U.S.C. 104, as amended by Sec. 3, Act of July 5, 1966, *supra*]. *Debts Which Have Priority.*

a. The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be * * * (4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy: *Provided, however,* That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: *And provided further,* That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court; * * *

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 6211. DEFINITION OF A DEFICIENCY.

(a) IN GENERAL.—For purposes of this title in the case of income, estate, gift, and excise taxes, imposed by subtitles A and B, and chapter 42, the term "deficiency" means the amount by which the tax imposed by subtitle A or B or chapter 42 exceeds the excess of—

(1) the sum of

(A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(B) the amounts previously assessed (or collected without assessment) as a deficiency, over—

(2) the amount of rebates, as defined in subsection (b) (2), made.

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SEC. 6212. NOTICE OF DEFICIENCY.

[Sec. 6212(a)]

(a) IN GENERAL.—If the Secretary or his delegate determines that there is a deficiency in respect of any tax imposed by subtitle A or B or chapter 42, he is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail.

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SEC. 6213. RESTRICTIONS APPLICABLE TO DEFICIENCIES; PETITION TO TAX COURT.

(a) TIME FOR FILING PETITION AND RESTRICTION ON ASSESSMENT.—Within 90 days, or 150 days if the notice is addressed to a person outside the States of the Union and the District of Columbia, after the notice of deficiency authorized in section 6212 is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. Except as otherwise provided in section 6861 no assessment of a deficiency in respect of any tax imposed by subtitle A or B or chapter 42 and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day or 150-day period, as the case may be, nor, if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final. Notwithstanding the provisions of section 7421(a), the making of such assessment or the beginning of such proceeding or levy during the time such prohibition is in force may be enjoined by a proceeding in the proper court.

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SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

[Sec. 6501(a)]

(a) GENERAL RULE.—Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, at any time after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

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SEC. 6503. SUSPENSION OF RUNNING OF PERIOD OF LIMITATION.

[Sec. 6503(a)]

(a) ISSUANCE OF STATUTORY NOTICE OF DEFICIENCY.—

(1) GENERAL RULE.—The running of the period of limitations provided in section 6501 or 6502 on the making of assessments or the collection by levy or a proceeding in court, in respect of any deficiency as defined in section 6211 (relating to income, estate, gift and chapter 42 taxes), shall (after the mailing of a notice under section 6212(a)) be suspended for the period during which the Secretary or his delegate is prohibited from making the assessment or from collecting by levy or a proceeding in court (and in any event, if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, until the decision of the Tax Court becomes final), and for 60 days thereafter.

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